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IN THE

Supreme Court of the United States

No. 130

BESSIE P. DOUGLAS, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

(C. C. A., Docket No. 12,461.)

No. 131

BESSIE P. DOUGLAS, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

(C. C. A., Docket No. 12,462.)

No. 132

ESTATE OF CHARLES H. ROBINSON, NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, JESSIE P. ROBINSON and CHARLES J. ROBINSON, Co-Executors,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

(C. C. A., Docket No. 12,463.)

No. 133

BERNICE B. DALRYMPLE, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

(C. C. A., Docket No. 12,464.)

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

To the Honorable Harlan F. Stone, Chief Justice of the United States, and the Associate Justices of the Supreme Court of the United States:

Bessie P. Douglas, Bernice B. Dalrymple, and Northwestern National Bank and Trust Company of Minneapolis, Jessie P. Robinson and Charles J. Robinson, as Co-executors of the Estate of Charles H. Robinson, deceased, respectfully pray for writs of certiorari to review the judgments of the Circuit Court of Appeals for the Eighth Circuit entered on April 7, 1943 (R. 94-96).

These judgments affirmed the decision of the United States Board of Tax Appeals (now the United States Tax Court) in the cases of Bessie P. Douglas vs. Commissioner of Internal Revenue, No. 12,461, and Estate of Charles H. Robinson, Northwestern National Bank and Trust Company of Minneapolis, Jessie P. Robinson and Charles J. Robinson, Co-executors, vs. Commissioner of Internal Revenue, No. 12,463, and Bernice B. Dalrymple vs. Commissioner of Internal Revenue, No. 12,464, and reversed the

decision of the United States Board of Tax Appeals in the case of Commissioner of Internal Revenue vs. Bessie P. Douglas, No. 12,462.

STATEMENT OF MATTERS INVOLVED

These cases involve the legality, under the Revenue Act of 1936 and corresponding provisions of later Revenue Acts and of the Internal Revenue Code, of treating as taxable income in the year 1937, amounts deducted as depletion against advance royalties over a series of years prior to 1937, in a case in which a mining lease was terminated in 1937 without extraction of ore during the term of the lease.

The taxpayers were the owners of fee interests in a tract of iron ore mining property. As lessors of that property, they received advance royalties under a mining lease in each of the years 1929 to 1936, inclusive. As provided by law, they claimed and were allowed deductions for depletion in each of said years. In 1937 the lease was cancelled by the mining company and no ore had been mined during the life of the lease. The aggregate of depletion deductions taken and allowed during the eight years prior to 1937 was subjected to taxation as gross income in the year 1937. Even deductions, which resulted in no tax saving when taken, were treated as income in the year of termination. The result of this treatment was a gross overstatement and distortion of the taxpayers' net income for the year 1937.

PROVISIONS OF STATUTES AND REGULATIONS INVOLVED

Section 41, Revenue Act of 1936:

"SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year."

Section 42, Revenue Act of 1936:

"SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *"

Section 23(m), Revenue Act of 1936:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

(In computing net income there shall be allowed as deductions:)

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commis-

sioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. * * *"

Section 113(b)(1)(B), Revenue Act of 1936:

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(A) * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

Article 23(m)-10(c), Regulations 94:

"If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

STATEMENT OF FACTS

The stipulated facts (R. 39-47) in each of the above cases, which were consolidated for briefing, argument and decision in the Circuit Court of Appeals and for the preparation of this petition, were adopted by the United States Board of Tax Appeals as its findings of fact (R. 49). With respect to the first issue presented by these cases, no material distinction exists in the facts and in the interests of clarity we shall set forth only the facts of the case of Bessie P. Douglas vs. Commissioner of Internal Revenue.

In the year 1929 Bessie P. Douglas, the owner of an undivided one-half interest in a certain iron ore mining property, together with owners of the remaining interests, leased the property to an iron mining company. In each of the years 1929 to 1936, inclusive, she received certain advance royalty payments required under the lease to be paid whether ore was mined or not but to be applicable upon ore later mined during the life of the lease. In filing her returns upon the cash basis in each of those years, she reported all of the royalties received by her and deducted amounts for depletion. These deductions were proper under the law and were allowed by the Commissioner. By making the deductions Bessie P. Douglas reduced her total income tax liability for the eight years 1929 to 1936, inclusive, by an aggregate of $6,923.51. In 1937 the lease was cancelled and no ore had been mined. The Commissioner added to the income reported by the taxpayer on her return for 1937, the sum of $53,299.03, which was the total of the royalty which went untaxed during the previous eight years. As a result her alleged net income was more than doubled and the tax imposed by reason of the inclusion in gross income of the aggregate of past depletion deductions was $26,550.65. In this way the Commissioner recovered all of the tax saved by

petitioner in the previous eight years, plus approximately $20,000.00. The Commissioner asserted the tax under the provisions of Article 23(m)-10(c) of Regulations 94, which provides as follows:

> "If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

The petitioner asserted that the regulation was invalid on the grounds that it was in conflict with pertinent provisions of the Revenue Act.

The second issue raised by these cases involves the taxability in 1937 of amounts deducted for depletion where no reduction in tax was effected by the deductions.[1] For example, the deduction by Bessie P. Douglas of $4,958.05 in 1933 resulted in no tax benefit to the taxpayer yet the Commissioner required its inclusion in gross income of 1937.

The Board of Tax Appeals held that the regulation was valid as applied to deductions of previous years which had offset taxable income but invalid as applied to the deduction of 1933, which resulted in no tax benefit (R. 57). The three taxpayers appealed from the decision holding the regulation valid and the Commissioner cross-appealed from that portion of the decision, holding the regulation invalid as applied to depletion deductions resulting in no tax benefit in the earlier years. The cases were consolidated before the Circuit Court of Appeals for the Eighth Circuit and on April

[1] This relates to the 1933 and 1934 deductions of Bessie P. Douglas and the 1932 deduction of Estate of Charles H. Robinson. The entire 1933 deduction was of no tax benefit and portions of the 1932 and 1934 deductions were of no tax benefit.

7, 1943, that court entered the following decision (R. 94):

As to the appeals taken by the taxpayers, the court affirmed the decision of the Board holding that an amount equal to the prior depletion deductions constituted income in 1937.

As to the appeal taken by the Commissioner, the court reversed the decision of the Board asserting that the fact that the depletion deducted in prior years effected no reduction in taxable income did not affect the validity of the regulation.

QUESTIONS PRESENTED

The issues raised by this litigation are as follows:

(1) Can the Commissioner of Internal Revenue lawfully require the lessor of a mining property to include in the gross income of the year in which a mining lease terminates the aggregate sum of amounts deducted for depletion in prior years against advance royalty payments, where no ore has been mined?

(2) If so, can this requirement be applied in the case of past depletion deductions which did not offset taxable income when deducted?

REASONS FOR ALLOWANCE OF WRITS OF CERTIORARI

1. The Circuit Court of Appeals, in deciding that amounts equal to depletion deductions taken from 1929 to 1936 constitute taxable income for 1937, has decided that it is proper for the Commissioner of Internal Revenue, by regulation, to cumulate items of receipt received in separate annual amounts in each of a series of years and to include the aggregate in taxable income of a subsequent year, and thus it

has decided a question of Federal income tax law in a way which is in conflict with applicable decisions of this court.

2. The Circuit Court of Appeals, in deciding that amounts equal to depletion taken from 1929 to 1936 constitute taxable income for 1937, has decided that it is proper for the Commissioner of Internal Revenue, by regulation, to adjust taxpayer's basis upwards by the amount of past depletion and to require the inclusion of a corresponding amount in the gross income of the year of lease termination, and thus it has decided an important question of Federal income tax law which has not been, but should be, settled by this court.

3. The Circuit Court of Appeals, in deciding that amounts equal to depletion deductions of prior years must be included in gross income in the year of cancellation of lease in spite of the fact that the deductions did not offset income or reduce income tax, has decided an important question of Federal income tax law which has not been, but should be, settled by this court.

WHEREFORE, your petitioners respectfully pray that writs of certiorari issue to the United States Circuit Court of Appeals for the Eighth Circuit in each of the above entitled cases, and submit their brief hereto attached in support of this petition.

Respectfully submitted,

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Dated: June 25th, 1943.

BRIEF IN SUPPORT OF PETITION FOR WRITS OF CERTIORARI

OPINIONS BELOW

The Opinion of the Circuit Court of Appeals for the Eighth Circuit rendered April 7, 1943—134 Fed. (2d) 762, is found at R. 85. The opinion of the United States Board of Tax Appeals (46 B. T. A. 943) is found at R. 47.

JURISDICTION

This petition is made under Section 240 of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938. The date of the judgments for which review is requested is April 7, 1943.

SUMMARY OF ARGUMENT

1. The Circuit Court of Appeals, in deciding that amounts equal to depletion deductions taken from 1929 to 1936 constitute taxable income for 1937, has decided that it is proper for the Commissioner of Internal Revenue, by regulation, to cumulate items of receipt received in separate annual amounts in each of a series of years and to include the aggregate in taxable income of a subsequent year, and thus it has decided a question of Federal income tax law in a way which is in conflict with applicable decisions of this court.

2. The Circuit Court of Appeals, in deciding that amounts equal to depletion taken from 1929 to 1936 constitute taxable income for 1937, has decided that it is proper for the Commissioner of Internal Revenue, by regulation, to adjust taxpayer's basis upwards by the amount of past depletion and to require the inclusion of a corresponding amount in

the gross income of the year of lease termination, and thus it has decided an important question of Federal income tax law which has not been, but should be, settled by this court.

3. The Circuit Court of Appeals, in deciding that amounts equal to depletion deductions of prior years must be included in gross income in the year of cancellation of lease in spite of the fact that the deductions did not offset income or reduce income tax, has decided an important question of Federal income tax law which has not been, but should be, settled by this court.

ARGUMENT

1. The Circuit Court of Appeals, in Deciding That Amounts Equal to Depletion Deductions Taken from 1929 to 1936 Constitute Taxable Income for 1937, Has Decided That It Is Proper for the Commissioner of Internal Revenue, by Regulation, to Cumulate Items of Receipt Received in Separate Annual Amounts in Each of a Series of Years and to Include the Aggregate in Taxable Income of a Subsequent Year, and Thus It Has Decided a Question of Federal Income Tax Law in a Way Which Is in Conflict With Applicable Decisions of This Court.

Separate annual deductions were taken by taxpayers from 1929 to 1936. By reason thereof separate annual portions of royalty received went free of tax because they constituted an apparent return of capital. An aggregate of $53,299.03 in depletion deductions was taken by Bessie P. Douglas over eight taxable years. An aggregate of $53,299.03 royalty *received by her in separate annual amounts over eight taxable years* went free of tax. In effect, the Circuit Court held that the $53,299.03 untaxed royalty of eight consecutive years constituted gross income of the ninth year in

which *none of it was received.* There can be no clearer case of cumulation of the income of many years.

This court held in *Burnet vs. Sanford & Brooks Co.* (1931), 282 U. S. 359, 51 Sup. Ct. 150, 75 L. Ed. 383, that an item of gross income received in a later year could not be drawn back to the year when related deductions were incurred. In effect, this court held that, where there is no accrual, *the time for inclusion in income is the year in which the item is received.* And that principle is clearly enunciated in Section 42 of the Revenue Act of 1936, which provides as follows:

> "The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, * * *."

The Circuit Court of Appeals decided that the items were received *prior to 1937*, but that because of the termination of the lease in 1937 their "status" as capital when received "then, and not until then, changes from capital loss to income both on the books of the lessor-taxpayer and for tax purposes" (R. 91).

Even were we to concede that there exists some process by which the "status" of an item can change from capital to income such a theoretical metamorphosis cannot change the fundamental and actual facts as to the time when the item was received. This court in the *Sanford & Brooks Co.* case, *supra*, has held that the *year of receipt* is the controlling factor and not the year in which an alleged change in "status" occurs.

By violating the fundamental rule as to time of receipt, by bunching items received in each of a series of years, the Circuit Court departed grossly from the principle laid down in *Burnet vs. Sanford & Brooks Co., supra*, that income taxes are to be determined on the basis of the taxpayer's

annual accounting period and on the basis of the net result of all transactions *within the year*. By permitting the cumulation of eight years' receipts the Circuit Court has sanctioned the imposition of surtax rates, designed only for annual incomes, against an unlawfully distorted net income containing the aggregate of incomes of many years.

The rule of *Burnet vs. Sanford & Brooks Co., supra*, has been applied or approved in subsequent decisions of this court and in numerous decisions of the courts below.

Helvering vs. American Dental Co., ... U. S. ..., 87 L. Ed. 574, 63 S. Ct. 577 (Mar. 1, 1943).

Snyder vs. Commissioner (1935), 295 U. S. 134, 79 L. Ed. 1351, 55 S. Ct. 737.

Helvering vs. Morgan's, Inc. (1934), 293 U. S. 121, 79 L. Ed. 232, 55 S. Ct. 60.

Harwick vs. Commissioner (1943), 133 Fed. (2d) 732.

See also Section 41, Revenue Act of 1936.

2. The Circuit Court of Appeals, in Deciding That Amounts Equal to Depletion Taken from 1929 to 1936 Constitute Taxable Income for 1937, Has Decided That It Is Proper for the Commissioner of Internal Revenue, by Regulation, to Adjust Taxpayer's Basis Upwards by the Amount of Past Depletion and to Require the Inclusion of a Corresponding Amount in the Gross Income of the Year of Lease Termination, and Thus It Has Decided an Important Question of Federal Income Tax Law Which Has Not Been, But Should Be, Settled by This Court.

The statutory authority for Article 23(m)-10(c) rests, if at all, only in Section 23(m) of the Revenue Act, the material portions of which provide as follows:

"In computing net income there shall be allowed as deductions:

* * * *

(m) *Depletion.*—in the case of mines, ... , a reasonable allowance for depletion . . . ., according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the secretary."

This court has held that this statute *requires* the Commissioner to permit the deduction of depletion from advance payments received prior to extraction.

Herring vs. Commissioner (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179.

This court has held that the taxpayer must take his deduction for depletion, if ever, in the year in which the advance payment is received and that he cannot wait until production commences.

Murphy Oil Co. vs. Burnet (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161.

Herring vs. Commissioner (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179.

The Revenue Act provides that even if the taxpayer refrains from deducting depletion his basis is reduced annually by the amount of depletion *allowable.*

Section 113(b)(1)(B), Revenue Act of 1936:

"(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of the property whenever acquired shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) GENERAL RULE.—Proper adjustment in respect to the property shall in all cases be made—

"(A) * * * * * *

"(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization and depletion, to the extent allowed (but

not less than the amount allowable) under this Act or prior income tax laws. * * * *"

The Revenue Act further provides that the basis for depletion shall remain fixed as reduced *even though it is found that prior depletion was excessive.*

"In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate *(but not the basis for depletion)* shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate." (Italics added.)

Section 23(m), Revenue Act of 1936.

In the face of this provision of the Revenue Act, the Commissioner assumes the authority to raise the basis upon termination of a lease and by a bookkeeping "credit" to assign a corresponding amount to the income of that year.

In view of the decisions of this court in the *Murphy Oil Company* case, *supra*, and in the *Herring* case, *supra*, the taxpayer is forced by regulation into the inextricable dilemma of (1) refraining completely from his granted right of deducting depletion, yet watching his basis reduced annually by the operation of Section 113(b)-1(B) or (2) subjecting himself to this floating and ever growing potential tax liability by exercising his lawful privilege.

Raising the basis by the amount of past depletion deemed excessive is, of course, the opposite of what must be done where there is excessive past depreciation. In such a case the basis remains reduced, and depreciation for the future is computed upon such reduced base.

Virginian Hotel Corporation vs. Commissioner, ... U. S. ..., decided June 7, 1943.

And the same procedure is prescribed for excessive past depletion by the above quoted portion of Section 23(m) for

a case in which, as the result of "operations or of development work," the depletion is discovered to have been excessive. Congress went to considerable pains to provide that the basis be not revised in this case. Yet the Commissioner feels free to raise the basis in a case identical in principle though not in detail.

Although a reference was made to Article 23(m)-10(c) of Regulations 94 by this court in the *Murphy Oil Co.* case, *supra* (wherein the point was not in issue), the question was specifically left open by the closing sentence of the opinion of this Court in the *Herring* case, *supra:*

> "As to income tax liability in the year of termination on account of bonus paid at the execution of the lease, if no mineral has then been extracted, we express no opinion."

We believe and we urge upon this court that the issue is an important one not only for lessees of oil, gas, mineral and other depletable properties whose leases have been terminated but it is a highly important one to have resolved for the guidance of those who are now deducting or are entitled to deduct depletion against advance payments. To condition by regulation the allowance of a deduction given by Congress in such a way as to make it more desirable to forego recovery of capital than to take the deduction, is in effect to tax the recovery of capital and to deny to the taxpayer the reasonable allowance provided by statute. The issue raised is one which should be put at rest by this court.

This issue has been litigated in the Fifth and Eighth Circuits and the validity of the regulation has been sustained by each court.

Lamont vs. Commissioner, 8th Circuit, 120 Fed. (2d) 996.

Sneed vs. Commissioner, 5th Circuit, 119 Fed. (2d) 767.

Crabb vs. Commissioner, 5th Circuit, 119 Fed. (2d) 772.

In none of those cases, however, did the taxpayer show the exaction of a severe penalty over and above the amount of tax savings resulting from use of the deduction.

3. The Circuit Court of Appeals, in Deciding That Amounts Equal to Depletion Deductions of Prior Years Must Be Included in Gross Income in the Year of Cancellation of Lease in Spite of the Fact That the Deductions Did Not Offset Income or Reduce Income Tax, Has Decided an Important Question of Federal Income Tax Law Which Has Not Been, But Should Be, Settled by This Court.

The Circuit Court held that the deduction of $4,958.05 taken by Bessie P. Douglas in 1933, which did not serve to offset taxable income or to reduce taxes in that year was nevertheless includible in gross income for the year of termination of the lease.[1] Its decision was based upon its previous decision in the case of *Harwick vs. Commissioner*, 133 Fed. (2d) 732, decided March 2, 1943 (R. 87, 93). This court granted certiorari in the *Harwick* case on June 14, 1943, Nos. 930-933.

The Circuit Court had previously sustained the regulation here involved on the ground that where the deductions had served to reduce income taxes in prior years it was only fair to recover the tax in the year of termination. *Lamont vs. Commissioner, supra.* Yet, when confronted with a case where the deduction was of no tax benefit it nevertheless sustained the regulation upon the authority of the *Harwick* case, *supra.*

The *Harwick* case involved amounts received in 1939 upon rescission of a stock purchase. The Eighth Circuit Court of Appeals held that a charge-off of capital loss prior to

[1]The principle here involved likewise applies to the 1934 deduction of Bessie P. Douglas and to the 1932 deduction of Estate of Charles H. Robinson.

1939, which did not result in tax benefit, closed the capital transaction and made the recovery in 1939 taxable income.

The same reasons for granting certiorari in the *Harwick* case, *supra*, together with the prevalent litigation regarding "tax benefit" theories justify the granting of certiorari in this case.

It is not believed that the recent decision of this court in the *Virginian Hotel Corporation vs. Commissioner*, ... U. S. ..., decided June 7, 1943, has resolved the question here involved. That decision apparently turned on the question of the definition of the word "allowed" as provided by Section 113(b)(1)(B) of the Revenue Act of 1936, hereinbefore quoted. In these cases an item of alleged gross income is involved rather than a deduction. In these cases past tax benefit has been made the very justification for the validity of Article 23(m)-10(c). *Lamont vs. Commissioner*, 120 Fed. (2d) 996. Yet the regulation has been extended to a case where there has been no past tax benefit.

CONCLUSION

For the reasons stated your petitioners respectfully pray that writs of certiorari issue to enable this court to review the judgments of the Circuit Court of Appeals in these cases.

Respectfully submitted,

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Dated: June 25th, 1943.